

**The Importance of Ethics in Auditing: Fraud and Ethical Breakdowns**

**An Honors Thesis (HONR 499)**

**By**

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**Abstract**

Ethics is an essential element of business. It provides guidelines and principles for decision making that promote the wellbeing of the general public, accomplished by students studying ethics in the United States. Despite the importance of ethics, fraudulent events can occur in business that are detrimental to the companies involved and the people attached to those enterprises. This paper discusses the importance of ethics in accounting. This paper analyzes the breakdown of ethical decision making in the Enron scandal, and reflects on personal encounters with ethics during internship experiences. The conclusion emphasizes the importance of increasing discussion of ethics in a college curriculum for faculty and students.

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### **Process Analysis Statement**

When beginning this thesis, I did not know what I wanted my topic to be nor did I know how to write this thesis. After meeting with Dr. Flasher multiple times, I decided to explore the topic of ethics in auditing. I thought that this subject would be something that would intrigue me and could develop the ethical lessons I learned during my two auditing internships. I kept notes of certain events that occurred during my internships and how my coworkers handled those situations. These personal experiences helped me to jumpstart writing my thesis.

After writing my personal section, I began to research the ethics definition and Enron sections of my thesis using articles, books, and journals. While researching these sections, I realized the vast amount of information that existed on the topic of ethics and Enron. One of my greatest struggles was trying to comprehend and condense the information. Another great difficulty for me was trying to decide the direction of my paper. There are many different focuses that a paper on ethics can take, but how could I make my thesis uniquely my own?

After discussing with Dr. Flasher my struggles with writer's block, I took the approach of writing all pieces of information that seemed relevant to ethics. Dr. Flasher recommended this approach because she believed that I would solidify the path of my thesis while writing about the various sub-sections of ethics. Overcoming my initial writers block was extremely difficult, and I struggled with this for each new section that I wrote. However, my sections quickly accumulated, which led me to my next challenge: revisions.

Revisions were another difficult process. I struggled connecting the main points of each section I had written, and I feared that my paper would sound like an accumulation of sections rather than a cohesive paper. To combat this fear, I visited the Writing Center many times, which helped me to have another opinion on the fluidity of my paper. Additionally, revisions were

tedious because it was difficult to see the progress I was making. When writing, it is easy to see the page numbers growing; however, revisions were not this obviously seen. Overall, this process was an interesting test of my education from the past four year. This paper has challenged me and made me excited to see all that I can accomplish in the future. This has helped me to recognize the depth of knowledge I have learned by reflecting on the curriculum I have followed at Ball State.

## **Introduction**

Many business professors shudder when they mention companies like Enron, and silence often falls over the class. Students, professors, and professionals know that Enron is one well-known example of the hundreds of companies throughout history who have faced public ridicule and hatred due to accounting scandals and fraud. If so many people know about and disdain the scandals that have happened throughout history, then why do fraudulent events continue to happen within companies today? This paper proposes increased discussion of ethics in discusses the history of ethics in accounting, analyses the ethical breakdown that occurred in the Enron scandal, and considers the importance of placing greater emphasis on ethics in a college curriculum.

## **Auditing History**

A current-day audit is an “objective examination and evaluation of the financial statements of an organization to make sure that the records are a fair and accurate representation of the transactions they claim to represent” (Audit, 2017). This section examines the history of auditing dating back to its start in Greece. This section explores the impact the Industrial Revolution had on auditing, and how the Joint Stock Companies Act placed the first substantial regulations on businesses. Finally, this section discusses the creation of the Securities and Exchange Commission (SEC), which is the regulating body in the U.S.

### **Greece**

Over the years, auditing has changed greatly in its practices and requirements. Auditing dates back to circa 350 BC in Greece, shown in Aristotle’s description of testing for embezzlement: “Ten... and ten... are chosen by lot. Every single public officer must account to them. They have sole control over those subject to [examination]... they place their findings



before the court” (Teck-Heang & Ali, 2008, p.2). Auditing focused on checking individual transactions by breaking the transaction down into detail. The goal of early audits was to verify the honesty of people who held financial positions. This idea of honesty and upstanding ethical values has continued to shape the auditing practice throughout history. As time progressed, audits became more substantial and more involved.

### **Industrial Revolution**

The Industrial Revolution sparked the need for the auditing profession. During the Industrial Revolution, regulations were largely non-existent. Many middle-class private investors funded the large capital requirements needed for factories. However, many of these companies failed, which had little effect on the company owners who would start new businesses using finances from new investors. In contrast, the investors suffered the greatest losses because they could not recoup their financial investments. Because the lack of regulations allowed companies to fail, the United Kingdom passed the Joint Stock Companies Act in 1844 (Teck-Heang & Ali, 2008, p.3). This act required the companies’ directors to balance the books and to create a “full and fair Balance Sheet” (Teck-Heang & Ali, 2008, p.3). Also, the act required auditors to check the companies’ accounts.

This act did not provide substantial regulation. The shareholders selected the ‘auditors required’ amongst themselves. These auditors were tasked with checking for the correct preparation of the financial statements, but they did not pay attention to internal controls. Additionally, the chosen auditor lacked the knowledge necessary to scrutinize the financial statements and company operations. This lack of expertise permitted companies to continue to act fiscally irresponsible, and therefore, the act did not accomplish the regulation it desired. Despite these shortcomings, the Joint Stock Companies Act moved the auditing profession closer

to today's standards while still focusing on providing correct and fair financial information, thus maintaining the ethical focus within the auditing practice.

### **Creation of the Securities and Exchange Commission**

Following the 1929 Wall Street Crash, the U.S. placed a greater emphasis on ensuring that the financial statements presented were reasonably correct because as the economy recovered, the general public began to re-invest in public companies. With the crash so fresh in people's minds, increased regulations were imperative to ease the general public's worry and to prevent future crashes. In 1934, the Securities and Exchange Act created the Securities and Exchange Commission (SEC). This board was tasked with creating accounting standards in the U.S. Additionally, this committee held the authority to oversee auditors (Byrnes, et al., 2013, p.2). The SEC delegated its responsibility to other governing bodies who create auditing standards but retained their statutory authority.

According to Teck-Heang and Ali (2008), "the audit function was mainly to provide credibility to the financial statements prepared by company managers for their shareholders" (p.4). Most of the audit standards arose as reactionary measures to the discovery of various fraudulent activities. Regulating bodies implemented standards and procedures for auditors to follow regarding each of the areas in which they discovered fraud. For example, McKesson and Robbins' fraud initiated the requirement for physical inspections of inventories. In McKesson and Robbins' fraud, "[f]ictitious inventories and accounts receivable comprised more than 20 percent of McKesson & Robbins' purported assets as of December 31, 1937" (Clikeman, 2003, p.1). Before regulations required physical inventory inspections, auditors took the word of the company's management. In October 1939, the American Institute of Certified Public



Accountants [AICPA] issued the Statement on Auditing Procedure (SAP) No. 1 that “required that auditors inspect inventories and confirm receivables” (Byrnes, et al., 2013, p.2).

As more fraudulent scandals occurred, regulating bodies developed and implemented additional auditing standards. In the cases of large or concurrent accounting scandals, regulating bodies made greater changes to the auditing procedures and requirements. At the heart of each of these changes was a fraudulent event and an ethical breakdown in the decision making of the company employees and auditors involved.

## **Ethics**

### **General Definition**

A general definition of ethics is the “inner-guiding moral principles, values, and beliefs that people use to analyze or interpret a situation and then decide what is the right or appropriate way to behave” (Jones & George, 2014, p.102). Ethics aims to act as guidelines or a set of moral standards for people to consider and follow when faced with ethical dilemmas. Often laws reflect the minimum generally accepted ethical standards. For example, U.S. law prohibits crimes such as murder, theft, etc, and society widely accepts these crimes as unethical and immoral acts.

Although murder, theft, etc. will likely continue to be seen as unethical and illegal acts, both law and ethical standards can change as time passes. For example, abortion was once seen as an abhorrent act, and therefore, the law reflected this view by prohibiting abortion. However, *Roe v. Wade* reversed this law as a growing portion of society grew to accept and support abortion. The discussion on the ethics of abortion continues as advocates both for and against the issue continue to make their case arguing their opinions. This example shows that as society changes, ethical guidelines also change.



## **Fraud**

By definition, fraud is “the crime of using dishonest methods to take something valuable from another person; intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right; an act of deceiving or misrepresenting” (Fraud, October 10, 2016). By its very nature, fraud violates general laws and ethics. Fraud can occur in various forms and magnitudes, from embezzlement to identity theft and multiple other forms. Fraud can be committed by one single individual or by a group of people. While most fraud is on a smaller scale, other fraudulent events make national headlines, which was the case in the Enron scandal.

## **Business Ethics**

As general ethics and laws change over time, business ethics and guidelines change as well. Business ethics are the examination of moral and social responsibility in relation to business practices and decision making. While social standards affect general ethics, different sources of ethics exist that contribute to the decision making process involved with business ethics. The four different sources of business ethics are societal ethics, occupational ethics, organizational ethics, and individual ethics. All four sources of ethics affect the business decisions that individuals make; however, each individual decision employs varying degrees of the four sources.

**Societal Ethics.** The first of the four different sources of ethics is societal ethics, which are “standards that govern how members of a society should deal with one another in matters involving issues such as fairness, justice, poverty, and the rights of the individual” (Jones & George, 2014, p.117). Societal ethics are a set of generally accepted standards for behavior and

decision making that governs what society as a whole views as morally correct. With societal ethics, people must take into consideration how their decision would be seen by the community.

**Occupational Ethics.** The second of the four sources of ethics is occupational ethics, which is a set of standards that “govern how members of a profession, trade, or craft should conduct themselves when performing work-related activities” (Jones & George, 2014, p.119). Different industries face vastly different situations. The medical field faces issues that differ from those of accountants, as all industries vary in how they handle ethical dilemmas.

Each industry has its own set of guiding principles that define acceptable decisions or actions. Within the accounting industry, the AICPA established the Code of Professional Conduct that accountants must follow. This code states acceptable behaviors for accountants. Additionally, this code places value on the integrity principle which states that “integrity is an element of character fundamental to professional recognition. It is the quality from which the public trust derives and the benchmark against which a member must ultimately test all decisions” (AICPA, 2016, p.5). The code goes on to explain that service to the public supersedes personal gain, and that a person of integrity does not allow deceit or “subordination of principle” (AICPA, 2016, p.6). Accountants, including auditors, must place the well-being of the public over their own ambitions and benefits, which requires accountants to act with integrity, objectivity, and honesty.

**Organizational Ethics.** The third source of business ethics is organizational ethics. These are the “guiding practices and beliefs through which a particular company and its managers view their responsibility toward their stakeholders” (Jones & George, 2014, p.121). Within organizational ethics, a company’s executives and management play a vital role in setting the expectations of the company’s ethical practices. Company management sets a code of



conduct which reflects the stated and implied values of the company. These codes of conduct are the corporate reflections of the stated, although not always practiced, ethical values of the organization. These values influence how employees view ethical decision making; however, not all people follow the company's stated code of conduct.

**Individual Ethics.** The fourth source of business ethics is individual ethics, which are the "personal standards and values that determine how people view their responsibilities to other people and groups" (Jones & George, 2014, p.119). Individual ethics relate most closely with the general definition of ethics stated previously, since both focus on an individual's personal beliefs, values, and actions. Childhood and upbringing shape individual ethics. The values learned in developmental years affect a person's individual ethics, which he/she carry throughout his/her life.

### **Rules for Ethical Decision Making**

In addition to the sources of ethics that affect business decisions, different rules for ethical decision making exist that describe the ways in which people weigh options when making ethical decisions. The four rules are the utilitarian rule, the justice rule, the moral rights rule, and the practical rule.

**Utilitarian Rule.** Under the utilitarian rule, "an ethical decision should produce the greatest good for the greatest number of people" (Jones & George, 2014, p. 113). This rule evaluates the ethics of a decision based on its overall effects across a wide span of people. Most decisions will affect some people positively and others negatively; however, this rule aims to make the best overall impact on the greatest number of people.

This can create its own challenges. First, how can the effects of a decision be evaluated across all people? Second, this rule deems a decision good or bad based on the outcome of a



decision. However, how can a decision be deemed good or bad when the actual results are yet to be revealed? Third, how can the rights and importance of various groups be evaluated? All three of these questions express that this rule can be difficult to implement.

**Justice Rule.** Under the justice rule, “an ethical decision should distribute benefits and harm among people in a fair, equitable, and impartial manner” (Jones & George, 2014, p.114). The basis of this rule is that people should not be treated differently. In essence, this rule looks to avoid favoritism and discrimination. For example, if two people have equal credentials and equal performance, then they should receive equal treatment regardless of race, religion, age, gender, etc. Additionally, people with unequal credentials should be treated fairly based on their level of expertise. If one person has a greater number of years of experience, then he/she should be compensated more highly than someone with fewer years of experience. When using this rule for ethical decision making, companies should remember that financial deceit does not adhere to the justice rule since the stakeholders and common public are not being treated equitably compared to the company’s employees and management.

**Moral Rights Rule.** Under the moral rights rule, an ethical decision should maintain and protect the fundamental rights and privileges of people (Jones & George, 2014, p.113). People have many inalienable rights upon which other individuals should not infringe. Individuals can maintain their own rights however they wish until they begin to threaten one another’s. Morally sound companies should uphold this standard of respect for others’ rights. Companies can respect human rights by respecting privacy, truth, health, and contract. Companies can respect privacy by securing the personal information of their employees and customers from theft or improper distribution. Companies can respect health by reducing waste and emissions that can harm their surrounding communities. Additionally, companies can also respect health by

ensuring that employees have safe work environments that cater to employees' physical and mental well-being. In addition, companies can respect the contracts with their customers, suppliers, and employees by making the contracts fair, honest, and understandable.

**Practical Rule.** Under the practical rule, an ethical decision should be one that a manager has no hesitation communicating to people outside the company. Assuming this was an ethical decision, a typical person in society would deem the decision as acceptable (Jones & George, 2014, p.114). If a person feels the need to hide his/her actions, then his/her decision would not pass the practical rule. A person's desire to hide his/her decision reflects the shame and worry he/she feels, which would suggest that this was not the ethically correct decision according to the practical rule. For example, a person who stole company money and covered his/her trail knows that his/her decision to steal was not ethically correct, hence the decision to cover his/her actions.

### **Enron**

Both the sources of ethical decision making and the rules for ethical decision making affect how people act when facing ethical dilemmas. Although most people are able to effectively choose ethical decisions, some people and companies struggle with making ethical decisions and find themselves in fraudulent situations, which was the case regarding Enron.

#### **The Beginning**

The Enron scandal shaped today's accounting standards. Enron emerged in 1985 after two natural gas companies merged. The union of Houston Natural Gas and Internorth created "the most extensive natural gas pipeline system in North America" (Clikeman, 2013, p. 236). At the time of the merger, Kenneth Lay, the Chief Executive Officer (CEO) of Houston Natural Gas, became the CEO of the combined companies. Lay's goal as CEO was to establish Enron's dominance in the market through increased financial growth; however, regulations at that time



inhibited pricing on the sale of natural gas, which limited the profits Enron could make through its sales. This would soon change.

### **Deregulation Sparked Change**

In the mid-1980s, deregulation of the natural gas industry occurred which allowed for the sale of natural gas at market prices. The ability to sell gas at market prices increased Enron's profit-making ability because Enron could charge higher prices when the market value rose. The ability for Enron to sell its natural gas at "spot" prices rather than using long term contracts provided more flexibility and increased profits. Spot prices are "the current prices in the marketplace at which a given asset such as a security, commodity, or currency can be bought or sold for immediate delivery" (Spot Price, 2016). Before this deregulation, Enron and other energy and commodity companies negotiated long-term contracts for the buying and selling of natural gas. According to Healy and Palepu, "these contracts assured long-term stability in supply and prices of natural gas" (2003, p. 5). This stability limited the profits that Enron could earn by preventing them from adjusting the price to the market highs and lows. Lay, Enron's CEO, saw this potential for greater profits through deregulation and used his connections to influence Congress to make natural gas a tradable commodity (Coelho, 2007, p.576). When this occurred, Enron's potential for profit growth expanded greatly, since Enron could now charge higher prices when the market value rose.

### **Diversification**

In addition, Enron pursued a diversification strategy. Enron expanded its operations beyond its pipeline business into natural gas trading, financial trading, and market making in "electric power, coal, steel, paper and pulp, water, and broadband fiber optic cable capacity"(Healy and Palepu, 2003, p. 5). This expansion into various markets cast a wide net



from which Enron could draw profit. In addition, this expansion impressed stockholders and capital markets. Enron's growth in various industries caused stockholders to value Enron's stock more highly; however, Enron would not be able to sustain this immense growth on its own. Enron would have become stagnant in the market and would have needed to find alternative methods of financial growth.

### **Key players involved in decision making**

Enron's growth is largely contributable to Kenneth Lay, Jeffrey Skilling, and Andy Fastow. These three executives played vital roles in Enron's growth and later demise. As CEO, Lay grew Enron from its early days following the merger through February 2001. Lay would return as CEO in August of 2001. During this time, he pursued the deregulation of the natural gas industry. Additionally, he oversaw Enron's diversification into various markets and business operations. As CEO, Lay hired Skilling in 1990. Skilling led Enron in its commodities trading efforts. Later, Skilling became Enron's president and chief operating officer. In 2001, Skilling would succeed Lay as CEO of Enron.

During his work as COO, Skilling created the gas bank, which acted as a financial institution that could provide buyers the ability to hedge or insure their purchases. Additionally, Skilling hired Fastow in 1990. Fastow was named the Chief Financial Officer (CFO) in 1998, and he also ran the Enron partnerships, also referred to as special purpose entities which played an important role in the demise of Enron (Healy and Palepu, 2003, pp. 5-8). The combination of these three executives, their desperate ambition, and their comfort with operating outside the rules led Enron to its demise.

## **What they did wrong**

Enron abused two accounting practices which allowed for them to operate outside the scope of what was deemed ethical and legal. The first of these two practices is mark-to-market accounting. According to Healy and Palepu, mark-to-market accounting meant

that once a long-term contract was signed, the present value of the stream of future inflows under the contract was recognized as revenues and the present value of the expected costs of fulfilling the contract were expensed. Unrealized gains and losses in the market value of long-term contracts (that were not hedged) were then required to be reported later as part of annual earnings when they occurred. (Healy and Palepu, 2003, p. 10)

In other words, Enron would record the revenue from the negotiated contract at its value on the date signed. If the value of the contract decreased, Enron would recognize the losses when they disposed of the contract. This practice of mark-to-market accounting is not illegal; however, Enron abused this accounting practice as a way to show falsely that their contracts and investments were higher than their actual book value. Many of Enron's contracts were for fifteen or twenty years. This great length of time in the natural gas market made it difficult for the parties involved to value the net present value of the contracts. In a market that was changing due to deregulation, accurately calculating the present value of net future cash flows was nearly impossible. Because of this difficulty, Enron could recognize billions of dollars of revenue in a current year without receiving the money in the current year. This falsely inflated their revenue because Enron would not recognize the losses until years later.

The second accounting practice that Enron used was special purpose entities (SPE's). According to Healy and Palepu, "special purpose entities are shell firms created by a sponsor



[parent], but funded by independent equity investors and debt financing” (2003, p. 10). If a SPE is a separate entity from the parent company, it must have an independent third-party owning at least three percent of the SPE’s total debt and equity and at least fifty percent controlling interest (Healy and Palepu, 2003, p.10).

If these requirements are fulfilled, then the SPE is separate from the parent company. If the two entities are separate and one entity buys the debt of the other, then showing a transfer of debt from one entity to the other is appropriate. Enron used this practice; however, the company falsely showed that its SPE’s were separate entities when, in reality, the requirements were not met. Enron moved its debt onto its special purpose entities so that investors would not see that Enron had accumulated debt in order to achieve its revenue for the year. By lowering their debt ratio Enron would appeal more to investors, which would cause stock prices to rise and generate more income for the company. Management’s abuse of these accounting practices would generate questions, bankruptcy, and eventually lawsuits.

### **The Downfall**

In 2001, doubt arose about how Enron earned revenues. This doubt created an environment where enough people questioned Enron’s operations that the truth was finally revealed. According to Lowery and Brinebry (2014), Bethany McLean wrote an article in March of 2001 in Fortune magazine questioning how Enron made its money (p. 333). This planted a seed of doubt about Enron’s success and viability. To further this doubt, Skilling’s actions as CEO enhanced negative views of Enron. Skilling lacked the poise and tact that a CEO of a large, well-known, public company requires.

For example, he called “Richard Grubman an ‘asshole’ after Grubman asked why Enron was slow releasing a balance sheet and cash flow statement for the first quarter” (Clikeman,

2013, p. 239). Grubman asked for the release of the balance sheet because the balance sheet adds to a full picture of a company's financial position. The income statement alone was misleading, which was why Skilling resisted its release. Skilling's tactless behavior continued to raise red flags, which reflected poorly on Enron. In August of 2001, Skilling resigned from his position as CEO. This abrupt resignation created shockwaves in the market's perception of Enron. According to Clikeman (2013), "Enron's stock price dropped 14 percent from \$43 to \$37 within the week amid speculation that undisclosed internal problems had driven Skilling from his post" (p. 240).

After Skilling stepped down, Kenneth Lay resumed his position as CEO. Shortly after returning, Sherron Watkins, the vice-president of corporate development, contacted Lay about concerns she had regarding Enron's questionable accounting practices. Watkins feared that the turmoil surrounding the change of executives would draw attention to their accounting practices. She stated, "I am incredibly nervous that we will implode in a wave of accounting scandals... Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting" (Clikeman, 2013, p. 240). Lay investigated the concerns Watkins mentioned about their accounting practices.

After discovering the allegations were true, Enron announced major losses, which were initially hidden by their questionable accounting practices. According to Clikeman (2013), "[o]n October 16, 2001, Enron announced a \$638 million loss for the quarter ended September 30" (p. 240). From this point, Enron's stock prices continued to fall drastically as more wrongdoings were discovered. By the end of November 2001, Enron's stock prices fell below \$1, and Enron declared bankruptcy at the beginning of December. A few small seeds of doubt created an



environment where enough people questioned the validity of Enron's disclosures that the truth was finally revealed.

### **Ethical Breakdown**

**Obstructionist Approach.** Enron's downfall stemmed from a breakdown in ethical decision making. Top management's strong desire to achieve growing profits led them to instill a business environment that was more focused on profits than it was on how it achieved those profits. Overall, Enron took an obstructionist approach to ethics. An obstructionist approach occurs when a company chooses not to behave in a socially responsible way and behaves instead unethically and illegally. This approach stemmed from Enron's executives who found great reward in producing high stock prices.

Enron experienced tremendous stock growth following its diversification strategy. However, this growth would have naturally slowed as Enron settled into its new markets. In addition, Enron's failed merger attempts inhibited their ability to continue their stock growth through the promise of company growth. Instead of allowing their stock prices to level off or even fall, Enron pursued its uses of special purpose entities and mark-to-market accounting as a means of maintaining increasing high stock prices.

**Importance of Bonuses.** Stock prices were valuable to Enron employees. Bonuses and stock options were a significant form of compensation for Enron executives. Because of the high reward for creating high short-term stock prices, many Enron executives found creative ways of producing company finances that would result in high stock prices. As executives at Enron began to focus on ways of increasing stock prices, a company culture was created that placed emphasis on stock prices above ethical accounting practices. The promise of large payouts motivated

executives and other employees with stock options to increase stock prices, while other lower-level employees complied with management's actions to meet company culture expectations.

**Application of the Practical Rule.** Enron's blind drive to achieve high stock prices regardless of the means of achieving them displays the company's ignorance of the practical rule. In regards to ethics, the practical rule causes the decision maker to think about how willing he or she would be to communicate their decision to people outside the company. In judging the ethics of a decision, a typical person would think that the decision is acceptable under the practical rule. In essence, the practical rule asks the decision maker to evaluate the societal ethics surrounding their decision. If a normal person in society would think that the decision was fair, just, and acceptable, then the decision would be deemed ethical under the practical rule. Enron ignored this rule, which was apparent when investigations began and Enron asked Arthur Andersen to destroy evidence of their accounting practices and wrongdoings. Destroying evidence suggests that the decision makers did not think that their actions would be accepted by a normal person in society.

**Application of the Utilitarian Rule.** In addition to the practical rule, Enron also ignored the utilitarian rule, which evaluates the ethics of a decision based on its production of good for the greatest number of people. By following accounting practices such as the wrongful use of special purpose entities, Enron ignored the greater good of the company and its stockholders in exchange for the benefit of the falsely achieving high stock prices, from which Enron executives received bonuses. By placing the good of the Enron executives over the good of the public, Enron ignored the utilitarian rule. This rule depends on the consequences of the actions. If the overall consequences were good for a large number of people, then the action taken was an ethical one.



Initially, Enron executives likely used the utilitarian rule as proper justification for their decision. This could have excused Enron's decisions of fraud and deceit, since the company was still listed as profitable. Additionally, operations were continuing like normal, and the executives were still making large profits. However, the false justification crumbled when Enron was exposed for fraud. The decisions to deceive the public caused tremendous turmoil and hardship for an extraordinary number of people in the general public; hence, this decision was not ethically acceptable under the utilitarian rule.

### **Auditors**

**Responsibilities.** In addition to the Enron employees' wrongdoings, a number of Arthur Andersen (Andersen) employees also committed fraudulent and criminal activities. As an independent auditor, Andersen's job was to look through Enron's financial statements in order to provide reasonable assurance that the numbers reported were materially stated. In addition, Andersen should have tested Enron's systems used to record transactions, as well as look into the overall set-up of Enron's operations. Independent auditors do not prepare the financial statements, nor is it their responsibility to fix the problems that they find. An auditor looks to make sure that the numbers presented are materially stated and that any problems found are documented and brought to the attention of the company.

**Wrongdoing.** In the case of Anderson, wrongdoing arose when Andersen employees attempted to cover up evidence of Enron's fraudulent activities. Enron was Andersen's second largest client overall, and the largest client for Andersen's Houston office (Clikeman, 2013, p. 241). The two companies worked closely with one another and many of the employees developed lasting friendships with one another. In addition, many of Andersen's employees eventually left public accounting to join Enron. The close relationship between Andersen and

Enron did not promote an environment of independence and professional skepticism. Instead, Andersen looked to maintain their close relationship with Enron in order to maintain Enron as their client, especially since Andersen's Houston office alone billed Enron \$52 million in 2000, of which \$27 million was from consulting fees (Clikeman, 2013, p. 241). Andersen likely feared that looking too closely into the accuracy of Enron's financial reports would cause Enron to grow to despise Andersen as their independent auditors.

Because of this desire to please Enron, Andersen remained lenient and did not scrutinize Enron's accounting practices. For example, Andersen allowed \$51 million of misstatements during 1997; however, Enron only reported net income of \$105 million (Clikeman, 2013, p. 271). This is a problem because Andersen allowed Enron to report financial information that could have been incorrect up to roughly half the amount of their net income. This amount of misstatements is unacceptable in today's standards, and it should not have been permitted at that time either. Although Andersen employees claimed that this amount of misstatements was immaterial, these errors were material, and Andersen should have required that Enron correct these misstatements. Andersen likely allowed these misstatements to go uncorrected because they did not want to upset Enron and lose them as a client.

This desire to put self-interest above the duty to the public is an example of how Andersen violated both the justice and utilitarian rule. Andersen's decisions should have benefitted the public; however, their choice to hide Enron's problems placed value on their own advancement rather than the good of the public. They unfairly valued their own interest above the public's interest which violated the justice rule by not allowing benefits and harm to fall in an impartial manner. Additionally, allowing fraud to continue which ultimately caused the demise of two large companies caused great turmoil for a vast number of people, which violates the



utilitarian rule by definition. By straying from the accounting code of conduct and ethics set forth by the AICPA (discussed in the Occupational Ethics section), Andersen allowed immeasurable harm to occur because of their unethical decision making.

Andersen employees' assistance in Enron's cover-up shows another example of their desire to maintain Enron as a client. Andersen employees shredded documents upon news that Enron was undergoing investigation by the SEC (Healy and Palepu, 2003, p.15). By shredding these documents, Andersen was committing obstruction of justice. This crime, which was meant to help save Enron as a company and therefore preserve their business with Andersen, effectively decimated Andersen across the globe. Andersen ignored the occupational ethics established by the AICPA, and in doing so, violated the utilitarian rule of ethical decision making. The AICPA's code of conduct established a set of principles for accountants to follow. This set of principles upheld the utilitarian rule by requiring accountants to act with integrity and to uphold service to the public above personal gain. In violating the AICPA's code of conduct, the Arthur Andersen's employees violated the utilitarian rule.

Additionally, shredding the documents indicates that Andersen was also violating the practical rule for ethical decision making. Andersen likely did not want the public to know their actions, which would indicate that they did not think their actions would have been accepted by a reasonable individual. This rejection shows failure of the practical rule.

Not only did Andersen face major legal problems, but they lost the value of their good reputation. By assisting Enron in an attempted cover-up, Andersen lost all credibility as a company with high esteem and ethical values. Regardless of the outcome of the legal battles Andersen faced, the extreme loss of good reputation associated with the Enron scandal and other concurrent issues caused substantial clientele loss that was irreversible. Other companies did not

want to associate themselves with the tarnished name of Arthur Andersen because it could cause the companies' own stockholders to question and fear the accuracy of their financial reports. As an auditor, one of the most important tools is a good reputation, which can be built by adhering to the professional code of ethics. A good reputation stems from accuracy, ethics, and honesty. When Andersen shredded documents after receiving pressure from Enron, Andersen lost their reputation as an honest company who followed ethical decisions despite pressure and temptations of wealth.

### **Implications of unethical decision making**

Although the effects of fraud may seem to have narrow effects, fraud can have implications that span from large corporations down to families. The apparent effects of fraud include punishment for the wrongdoers and the loss to the company that the fraud created. An example of this could be embezzlement. The company from which money is being embezzled is affected by this type of fraud because it is unknowingly losing money. This money could have increased profits or cash funds, which could have allowed the company to grow and reinvest in itself and its workers. However, the loss of this money deprived or at least limited the company of this chance for growth. Additionally, the embezzler could face fines and imprisonment, and he/she could lose family, friends, and job if caught.

Although fraudulent activities may seem limited to the wrongdoer and the company, fraud can affect many other people. In the case of Enron, a few executives spearheaded fraudulent activities that affected more than the company itself. As the fraud was uncovered, stock prices fell drastically, and by the end of 2001, Enron declared bankruptcy. Although the fraud was limited in the number of participants, thousands of people were affected by its outcome as will be subsequently discussed.



**Job Loss.** First, the thousands of other innocent employees at Enron were affected by the fraud because the bankruptcy caused Enron employees to lose their jobs. Additionally, these workers also suffered losses to retirement plans since many employees had invested in Enron. In addition the families, local communities, customers, and vendors all suffered because of Enron's collapse. Enron was a large company, so its collapse created a large void. Families of employees lost sources of income. Unemployment increased, which negatively affected communities that were home to many Enron employees. Additionally, the customers and vendors were forced to search for a new company with whom they could conduct their business.

**Stockholders lose value in stock.** Second, stockholders were negatively affected by Enron's demise because they lost all value in Enron's stock.

**Arthur Andersen's damaged reputation.** Third, Enron's collapse affected Anderson due to their close relationship which created a liability for Anderson that held them partially responsible for the hidden delinquent activities at Enron. This shift of blame onto Anderson caused Anderson effectively to go out of business as well. This affected Anderson's employees, and their families. When Andersen employees in the Dallas office shredded documents related to the SEC's investigation of Enron, the actions of the small number of Andersen employees caused Andersen employees across the world to lose their jobs. Andersen went out of business, which caused Andersen employees without connections to Enron or the Dallas office to lose their jobs. Although this poor ethical decision would appear only to affect the Andersen employees directly involved, the delinquent actions affected Andersen offices worldwide. One instance of fraud can create a domino effect that negatively impacts many innocent people.

## **Personal Experience**

### **Timesheet Dilemma**

During the internship experience undertaken by my cohort of interns, ethical decisions were experienced on a small scale. The main ethical decision experienced by this cohort was recording timesheets. Interns were paid on an hourly rate based on the number of hours worked each week, with hours in excess of forty hours per week paid on a time and a half rate.

The prospect of receiving overtime pay for interns working during busy season is enticing to college students. Busy season often requires extended working hours that can average roughly sixty hours per week. Because interns are paid hourly with the strong possibility of overtime pay, many students choose to do busy season internships because of the promise of large payouts. Students can use this money to pay for tuition, housing, student loans, etc, as was the case for many interns in my cohort.

Despite the promise of overtime pay, the company implemented a new policy that limited the number of hours interns could work to forty hours per week during busy season for my cohort of interns. This company policy attempted to increase intern satisfaction and overall retention for interns who were offered full time positions upon completion of their internship. This limit on the number of hours that interns could work created a couple dilemmas.

The first dilemma arose when interns' seniors would ask throughout the week how many hours the interns had already worked. Knowing the hours worked neared forty hours, interns had two options. The first option would be to tell the senior that he/she had worked 35 hours, for example, which would likely result in the intern being sent home early. The second option would be to lie to the senior saying a smaller number of hours than had actually been worked.



The first option would mean that the intern would be sent home early the rest of the week. This may seem like an exciting choice; however, this meant missing out on learning opportunities during the time after being sent home and also meant missing the chance to earn overtime pay. The second option of lying to the senior about the number of hours worked would allow interns to be present for any learning opportunities available throughout the week. In addition, this second option would allow interns to work overtime hours, which presents a second ethical dilemma: should the interns record the extra hours worked about which they had previously lied?

If interns lied about the number of hours worked, then they could have earned more overtime pay. The dilemma that arises with this is the number of hours that interns should record. Should they record only forty hours or should they record the total number of hours actually worked [in the case that they worked over forty hours]? If they recorded the total number of hours, then they could potentially face reprimand from their superiors for failing to follow the limited hours. Additionally, interns could face reprimand for lying about the number of hours worked. In contrast, interns could record only forty hours, but this would also be a moral compromise because this would be lying.

### **Sources of Ethics**

Framing my cohort's situation within the ethics schools discussed earlier, I will discuss individual, organizational, and occupational ethics.

**Individual Ethics.** When considering this situation and the dilemmas that ensued, the various sources of ethical decision making affected interns' decisions. First, individual ethics were the major deciding factor in this situation. An intern's upbringing and current home situation influences the ethical attitudes of an individual in the workplace. For some, honesty

pervades all matters, regardless of the personal cost or possible retributions from that honesty. Keeping this in mind, some interns felt a strong urge to tell the truth when initially asked how many hours they had worked to that point during the week. By telling the truth initially, these interns avoided the other ethical dilemmas that follow the initial lie.

**Organizational Ethics.** Another source of ethics that affected interns' decisions was organizational ethics. The company that employed my cohort of interns expressed the importance of honesty and integrity. Various interns felt that honesty would be the best way of acclimating to the company's culture. Acclimation was important to the cohort of interns because many interns hoped to gain a full time job offer upon completion of the internship process. Upholding the company's core values helped the cohort to make favorable impressions on the company, which led the company to extend full time job offers to each audit intern from my cohort.

**Occupational Ethics.** Finally, occupational ethics influenced interns' decisions not to lie. Accountants are expected to have high moral values and be upstanding figures of good ethics. Many interns from my cohort wished to pursue a lifelong career as accountants, and they wanted to begin their careers on the correct path by practicing honesty and good ethics. Practicing good ethical decision making in small risk scenarios will help to implement good decision making in other higher risk areas. If a person cannot make an ethical decision in a small situation, then how can they truly be trusted to make the correct decision in a larger situation? Various interns from this cohort wanted to make sure that they practice ethical decision making in all aspects of their careers even in something as seemingly insignificant as the number of hours worked in a week. In the future, these interns will continue to practice good ethics by following the AICPA code of conduct which will keep integrity at the forefront of their actions.



Something as small as answering a question on how many hours worked during a week can turn into a downward spiral of lies and cover-ups. Once a lie is begun, it is difficult to end. More lies must be told to cover up the first lie, but as more lies become involved, the trail of lies becomes more difficult to remember. This cover-up can be difficult to avoid getting caught. Additionally, this repeated behavior can become a habit, which can be used in decision making on matters larger than one week's timesheet. A small lie can become a slippery slope that can lead to a large fraud.

### **Importance of Ethics in Curriculum**

In many cases, making ethical decision can often be viewed as common sense. Most people remember lessons of right and wrong being taught since childhood. Generally speaking, people know right from wrong; however, each situation presents its own set of circumstances, making every situation different and unique. The circumstances that surround each ethical decision can cause people to question the ethics of their decision. People often use the circumstances of their decision to justify the ethics of their decision.

For example, a person may decide to steal money from a company. The basic act of stealing is viewed as unethical. However, if a person takes a small amount of money from a company to buy food for their children with the intention of paying the money back a few days later, then the decision to steal money is difficult to determine as unethical because of the circumstances surrounding it. The act of stealing is still the same; however, the circumstances are different. Buying food for children is seen as ethical, and repaying the money makes the act seem like a loan rather than theft. However, the basic premise of the act is still theft. Is this decision ethical?

### **Implicit and Explicit Pressures from Employers**

Ethical decision making can be a challenge for many people, including students preparing to enter the workforce. These young professionals may feel the implicit and explicit pressures to perform certain actions that may be unethical. Students may not resist the pressure to act unethically since they may feel they must perform certain actions in order to acclimate to their new workplace. Additionally, students may not view small unethical decisions as a big deal since little emphasis is placed on ethics within course curriculum. The decisions may seem small initially; however, the decisions may grow in magnitude as the students gain more responsibilities within their companies. The initial pressure to act unethically may lead students down a slippery slope toward larger unethical decisions.

### **Ethics in Education**

Colleges should offer greater exposure to ethics within course curriculum. This exposure can be offered in multiple ways.

**Ethics Specific Course.** The first option would be to include an ethics course within the general business curriculum. Within this course, student would research various ethical dilemmas that have occurred in history. These dilemmas can span across the different business focuses such as marketing, accounting, finance, risk management, human resources, etc. These research projects can help to provide students with examples of ethical dilemmas that arise in their chosen fields. This helps to provide insight for students into different situations that they may face, and various ways that they could handle those situations. Additionally, these cases can help students to see the importance that ethics has within each of their fields.

**Ethics Lessons within Existing Courses.** A second possible way that ethics could be included within course curriculum is as a lesson within each course. Professors can present



students with ethical situations that relate to the topics being taught. Professors can then ask students how they would handle those situations. Although many courses would struggle to set aside an entire lesson on ethics, professors could incorporate ethical teachings within lessons by prompting students with a situation relating to the topic and how the student should handle it.

### **Conclusion**

Ethics holds an important role in everyday business decisions. It affects the company, the employees, the stockholders, and the general public. Ethical decision making presents itself in both large and small situations, and both recent college graduates and experienced workers can struggle with choosing the ethically correct decision. Small decisions, like an intern completing his/her timesheet for the week, may seem harmless; however, practicing many small unethical decisions can place workers on a slippery slope that can impair their decisions in larger decisions, such as the Enron executives using incorrect accounting practices which ultimately led to Enron's demise. Overall, practicing good ethical decision making is important because it instills integrity and honesty, which are both vital to the long-term success of a business person.

The aim for studying ethics is to educate people of how easy it is to make unethical decisions. These decisions can be justified by twisting the rules for ethical decision making to support the unethical decision being made. This twisted logic has allowed fraud to occur in the case of Enron, Arthur Andersen, and other companies as well. By making people more aware of how easy unethical decisions can be, people will hopefully be more diligent in their own actions and will also look to make sure that their peers are maintaining good ethics.

Although people may be aware of the ethical decision making process, knowing exactly what people are thinking and feeling while making decisions is impossible. This limits the ability for management to set forth guidelines that will completely prevent unethical decisions. In

addition, the complexity of the decision making process and the complexity of the various influences on an individual make determining the future decisions that a person will make impossible. Certainly, employers do not want to hire someone that they know with certainty would make unethical decisions that could cause the demise of the company; however, employers cannot know with certainty whether or not the person they are interviewing will make ethical or unethical decisions.

Employers can use training workshops to try to influence their employees to make ethical decisions; however, societal, individual, and occupational influences also affect an individual's decision making process. Perhaps with more study, employers will be able to better learn how the innumerable influences affect each individual's decisions, which would turn this limitation into a great opportunity for a company to choose the most upstanding individuals for their companies and avoid the destruction that Enron and Arthur Andersen faced.



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